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Liquidity strategies

Quarterly Overview

30 June 2024

Overview

Market overview

Markets have once again been dominated by interest rates during the quarter, despite little or no movement in this area. 2024 started with expectations that central banks would cut early and cut often. However, as the year has progressed, those expectations have changed. Inflation has generally not come down quite as fast as hoped, with services inflation proving sticky, particularly in the UK, while growth has generally not been as weak as feared – particularly in the US. Interest rates were cut just once across the Federal Reserve, European Central Bank and Bank of England, with the ECB cutting rates in June. Most central bank forecasters now only expect one or two cuts from each of these banks over the course of 2024 as a whole.

Ahead of the US Presidential elections in November, snap parliamentary elections were called in the UK and France, providing reminders that voter dissatisfaction with the seeming consensus on economic policy and ongoing lack of consensus on longer-term issues such as climate change create an uncertain backdrop for businesses and consumers alike.

Data released in the UK in the second quarter confirmed that the country bounced out of technical recession in the Q1 and painted a picture of continued positive economic growth. First quarter GDP rose 0.7% quarter-on-quarter in real terms after falling 0.3% in the fourth quarter. Meanwhile inflation also dropped back to the Bank of England's 2% target. The rate of change in the CPI basket fell from 3.4% year-on-year in February to 2.0% in May, helped by lower electricity and gas bills. The Bank of England kept rates at 5.25%, even though headline inflation dropped. This reflected concern about services inflation and pay growth, both of which remain elevated. The calling of UK general election, which has resulted in a change of government, had minor impact on sterling asset prices, reflecting a view that there would be little shift in economic policy.

UK government bonds produced negative returns due to rising yields, delivering a -0.89% return (FTSE Actuaries) over the second quarter with the benchmark 10-year gilt yield rising from 3.94% to 4.18%, with yields rising sharply at the start of the quarter, then largely trading in a range between 4.1% and 4.3% for the rest of the quarter – a similar pattern to that seen in the first quarter. The sterling investment grade credit market (iBoxx non-gilt index) returned -0.13% over the quarter, with the average sterling investment grade credit spread (the average extra yield available from non-gilt bonds compared with government debt of equal maturity) widening marginally from 1.02% to 1.03% (iBoxx).

UK money market rates were generally flat during the quarter, with some volatility at the longer end of the money market curve as rate expectations changed over the course of the quarter to reflect fewer and later rate cuts in 2024. SONIA started the quarter at 5.19%, and after edging higher to 5.20% early on, remained unchanged for the rest of the quarter, as UK base rates remained unchanged at 5.25%. from the Bank of England, while two-year gilts, often seen as a proxy for market expectations of BoE rates, saw some spikes as rate expectations were pushed back, but ended only slightly higher, from 4.18% at the end of the first quarter to 4.22% at the end of June.

Performance and activity

After a period of rising interest rates through 2022 and most of 2023, short-term money markets have essentially been flat in 2024. We have moved from peak optimism at the end of 2023 where economists were calling for five or even six rate cuts in the US in 2024. We have now almost reached peak pessimism as the same economists are calling for only one cut. Our own view was always more cautious than market consensus and we were very selective in adding longer-dated paper where market rate reflected that overly optimistic view that UK rates would be nearer 4% by the end of the year.

However, for our portfolios, this has been a period where we have benefited from activity in previous quarters where we built up portfolio yield. The high level of carry in the portfolios has been a consistent factor in recent strong returns.

For the **Sterling Liquidity Fund and Short Term Money Market Fund**, we still focus on short paper – reflecting the funds' objectives. Our focus in recent months has been at the shorter end of the money market curve. As the quarter progressed and the market has moved to price in a more cautious view on rate cuts, we have added more to longer-maturity paper as this now offers better value than was the case six months ago.

Technical factors helped drive greater use of overnight repo – as the Bank of England (BoE) has been draining liquidity from the banking system due to the unwinding of its quantitative easing programme (known as quantitative tightening, or QT) – also pushing repo rates higher. As a result, we have been happy to use repo more in the portfolio – the combination of secured lending, daily liquidity and rates at or above overnight lending made this an attractive area. At the same time, our activity in treasury bills decreased slightly, reflecting better value in CDs.

Overview

Issuance of certificates of deposit (CDs) has increased slightly over the quarter. In line with the objectives for these portfolios, most activity in this area is focused on short-dated paper, such as three-month CDs from Bank of Nova Scotia, KBC and United Overseas Bank. Ahead of the BoE meeting in June we took advantage of better long-term rates to lock in some of those rates, looking for maturities in early 2025 that therefore avoid maturing just head of the year end when liquidity can be somewhat lower than normal. Examples included nine-month paper from Macquarie Bank, which scored well in our reviews and adds to overall diversification, and one-year paper from HSBC. We also added one-year floating rate CDs from ING, locking in a healthy premium over SONIA.

For the **Short Term Fixed Income Fund**, covered bonds still account for the majority of non-money market exposure. These were helpful for returns over quarter as these pay a premium over SONIA, while the carry built into the portfolio was also helpful.

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Covered bond activity was a little higher than in previous quarters. During the period we added new issue covered bonds from DBS Bank and WestPac Banking, as well as a new issue of a five-year covered bond from Federation des Caisses Desjardins, also adding to this in the secondary market.

For the **Short Term Fixed Income Enhanced Fund**, performance over the quarter was positive in absolute terms – primarily due to the high yield built into the portfolio. There were no material yield moves affecting performance, while credit spreads were broadly flat over the quarter.

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We continued to use short-dated gilts to maintain duration and benefit from the higher yields on offer as the market re-priced the potential for UK interest rate cuts, although this activity reduced as the period went on and we found better value elsewhere.

In short-dated credit, we added new issue covered bonds from Toronto Dominion and WestPac Banking, also adding new issue secured bonds from PCL funding, who provide financing for lump sum insurance, professional fees and school fees and Exmoor Funding, an RMBS based on prime and near-prime residential mortgages, including retirement interest-only mortgages, with low LTVs.

Outlook

At the start of this year we felt that the market was expecting too many rate cuts. That is a view that did not really change through the first half of the year – even as the number of forecast rate cuts was reduced, we felt that it was overly optimistic. At the same time, technical factors including the increased use of the Bank or England repo facility and reduced CD issuance have distorted market rates, providing opportunities for active managers.

At the end of June, the possibility of UK rate cuts in the next quarter appears to be increasing. The return of headline inflation to 2% does appear to give the Bank of England the freedom to cut rates, while any reluctance to cut just ahead of a general election will have disappeared after July 4. However, much of the impetus for that fall to 2% has come from base effects rather than underlying inflationary forces, as shown by services and wage inflation that is near 6%. Hence our expectation that we are likely to see only one rate cut this year, unless the growth outlook weakens considerably.

Although the next move in rates is expected to be a cut, the timing of that move remains unclear. Across our strategies, we aim to mitigate this risk partly by taking selective exposure to longer maturity assets, but also through floating rate exposure where available at attractive rates. These lock in an additional spread over SONIA and provide protection in both a rising and falling rate environment.

We continue to incorporate assessment of ESG risks in our holdings. While the primary consideration in looking at a bank will be assets and cashflows, ESG risks are increasingly material as seen with the zero / low exposure to Credit Suisse last year, where we had concerns over the governance at the bank. In addition, we believe that our exposure to covered bonds also helps manage risk, with these being regulated instruments and exempt from bail-in, so if a bank does get into difficulty, these assets are not bailed into the wind-up process.

Further Information

Please click on the links below for further information:

Stewardship and responsible investment at RLAM

Royal London Sterling credit ESG analysis

TCFD climate report

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